

Chapter 9

Municipal Bankruptcy: Pipe Dream or Panacea?



By Robert E. Nies, Esq.
Member, Bankruptcy Law Group,
& Patrick O'Reilly
Associate, Wolff & Samson PC

New Jersey municipalities face a potentially lethal combination of drastically reduced state aid, dwindling tax revenues from depressed real estate prices, record-high unemployment figures, an ever-decreasing commercial and residential tax base from an unremitting tide of foreclosures, generous, yet under-funded pension obligations and the curtailed ability to provide basic municipal services due to layoffs and budget cuts. As a result, many New Jersey cities and towns, as well as their fiscally constrained political subdivisions and agencies, will necessarily entertain the once unthinkable: Chapter 9 Adjustment of Debts of a Municipality.

That federal option, however, may prove elusive and, for practical purposes, unavailing in New Jersey, a state in which only two municipalities have even attempted to file for bankruptcy protection in the last 75 years. This article will explore the interplay between Chapter 9

and N.J.S.A. 52:27-1, et seq., the statute governing whether, and upon what terms, a New Jersey municipality may avail itself of the benefits of Chapter 9.

Chapter 9 Background Chapter 9 creates an inherent constitutional tension between a state's "retained" powers under the 10th Amendment and the federal government's supremacy clause, because our Supreme Court has held that states are principally responsible for granting and withdrawing the powers of municipalities and, therefore, Congress' grant of power to municipalities to file for bankruptcy violated these retained state powers. Ultimately, in *U.S. v. Bekins*, 304 U.S. 27 (1938), the Supreme Court held that a newly enacted statute did not violate the 10th Amendment, because it was carefully drawn so as not to impinge on the sovereignty of the state. Today, section 109(c) of the Bankruptcy Code expressly provides that municipalities may only file a Chapter 9 bankruptcy petition if state law specifically authorizes them to be a debtor.

Current New Jersey Law In *Faitoute Iron & Steel Co. v. City of Asbury Park*, 21 A.2d 796 (N.J. Err. & App. 1941), the constitutionality of New Jersey's bankruptcy enabling legislation was challenged and, eventually, the case was argued before the United States Supreme Court. See *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942). The Supreme Court affirmed the decision below and declined to find the New Jersey statute unconstitutional. *Id.* Accordingly, a New Jersey municipality, before filing a petition, must first obtain the approval of Local Finance Board of the Division of Local Government Services. N.J.S.A. 52:27-1 (footnote 2). While the criteria for approval by the Local Finance Board is obscure, the factors considered when certifying a plan of adjustment or composition of creditors' claims under N.J.S.A. 52:27-39 are instructive.

This nebulous and untested criteria for state approval to file for bankruptcy is a significant barrier to Chapter 9. The City of Asbury Park was facing insolvency and was placed under the control of the Municipal Finance Commission in February 1936.



Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502, 505 (1942). Bankruptcy was averted because the New Jersey Municipal Finance Commission adopted a plan for the refunding of its bonded debt. *Id.* at 505-06, 509.

More recently, the City of Camden filed for bankruptcy protection in the United States District Court for the District of New Jersey on July 19, 1999. The State of New Jersey sought to dismiss Camden's bankruptcy petition because Camden had not first sought the State of New Jersey's approval to file the bankruptcy. The process to obtain Local Finance Board approval was never consummated, because within days of the filing Camden withdrew its bankruptcy petition, in exchange for the infusion of \$62.5 million in state aid to Camden's budget.

Chapter 9 Overview Section 109(c) provides the eligibility requirements for becoming a debtor under Chapter 9. An entity may be eligible only if it is (1) a municipality; (2) authorized to be a debtor under Chapter 9 by state law; (3) insolvent; and (4) willing to adjust its debt by implementing a plan. Separately, a municipal debtor must demonstrate that it: (1) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that will be impaired under the plan; or (2) has negotiated in good faith with creditors but has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that will be impaired under the plan; or (3) is unable to negotiate with creditors because such negotiation is impracticable; or (4) reasonably believes that a creditor may try to be the recipient of a transfer (e.g., payment) that would otherwise be avoidable as a preference. Only one of the four latter requirements need be present.

The Bankruptcy Code defines a municipality as a "political subdivision or public agency or instrumentality of a State." 11 U.S.C. § 101(40). In general, a political subdivision of a state includes a county, parish, city, town, village, borough or township. See, *In re County of Orange*, 183 B.R. 594, 601 n.16 (Bankr. C.D. Cal. 1995). A public agency or instrumentality generally refers to an entity that is organized for the purpose of constructing, maintaining and operating revenue-producing enterprises.

See, Bankruptcy Act § 81(1); 11 U.S.C. § 404 (1976). The source of the revenue may be taxes, assessments or income-producing property. *Id.* School districts, hospital districts, municipal waste authorities and energy authorities are public agencies or instrumentalities. *Id.*

Section 904 of the Bankruptcy Code limits the power of a federal court to compel a municipal debtor to take almost any action in bankruptcy. This section codifies the 10th Amendment's general prohibition on a bankruptcy court's power to interfere with a state entity. See 6 COLLIER ON BANKRUPTCY ¶ 904.01 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. Rev.) ("Section 904 complements Section 903 in providing a constitutional shield for Chapter 9 by limiting federal intrusion upon States' rights.") Thus, a bankruptcy court may not interfere with a Chapter 9 debtor's governmental powers, or the use of the debtor's property, without the debtor's consent. *Id.* In practice, this section prohibits bankruptcy courts from mandating that a Chapter 9 debtor make specific payments in violation of the 10th Amendment. See, e.g., *In re County of Orange*, 179 B.R. 195, 199-200 (Bankr. C.D. Cal. 1995).

The Benefits and Pitfalls of Chapter 9 Chapter 9 shares many legal attributes of all bankruptcies, including the breathing space accorded by the automatic stay prohibiting creditor enforcement action. See, 11 U.S.C. §§ 362 and

901. But Chapter 9 at its core is an "adjustment" of debt obligations and not the "discharge" of liability typically sought in either a Chapter 11 reorganization or Chapter 7 liquidation under the Bankruptcy Code. This adjustment is accomplished, in large part, with the cooperation and consent of various creditor constituencies, although a plan of adjustment may be confirmed under certain circumstances over the objection of a class of dissenting creditors.

One of the real benefits of Chapter 9 is the ability of a municipal debtor—provided certain conditions are met—to reject executory contracts, including employment contracts for highly compensated executives, onerous collective bargaining agreements, disfavored or unprofitable waste removal contracts and, arguably, pension obligations. The ability to alter the obligations under these kinds of contracts, if nothing else, is a tremendous cost cutting and cost saving tool.

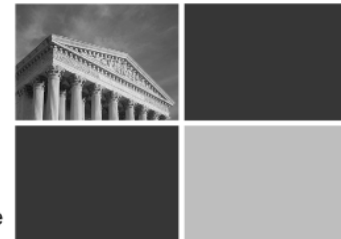
In New Jersey, unfortunately, the rarity of any municipality having actually followed through with this kind of business option, and the concomitant uncertainty that Local Finance Board approval to file bankruptcy might be forthcoming, relegate Chapter 9 to a relatively theoretical alternative. Accordingly, state legislation delineating the conditions for Local Finance Board approval would at least make Chapter 9 a viable business option for New Jersey municipalities. ▲

WOLFF ■ SAMSON

Because the fine print isn't always fine.

Wolff & Samson has a long-established and highly regarded practice assisting businesses with their most important projects. We offer counsel in many areas, including:

- Bankruptcy and Creditors' Rights
- Corporate and Securities
- Environmental
- Government and Regulatory Affairs
- Litigation
- Public Finance
- Real Estate, Development and Land Use



Wolff & Samson PC | Attorneys at Law | www.wolffsamson.com
 One Boland Drive, West Orange, NJ 07052 | (973) 325-1500
 140 Broadway, 46th Floor, New York, NY 10005 | (212) 973-0572
 128 West State Street, Trenton, NJ 08608 | (609) 396-6645

Attorney Advertising